BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

DA 96-54

In the Matter of	)	
	)	
1995 Annual Access Tariffs	)	**CC Docket No. 96-5**
	)	
GTE Telephone Operating Companies	)	**Transmittal No. 963**
GTE System Telephone Companies	)	**Transmittal No. 146**

ORDER DESIGNATING ISSUES FOR INVESTIGATION

Adopted: January 23, 1996; Released: January 23, 1996

FILING SCHEDULE:

Direct Case: February 20, 1995
Oppositions/Comments: March 5, 1996
Rebuttal: March 19, 1996

By the Chief, Common Carrier Bureau:

I. INTRODUCTION

1. On July 21, 1995, the Common Carrier Bureau (Bureau) released the *Price Cap Carriers' 1995 Annual Access Order*[1] which, *inter alia*, suspended for one day and initiated an investigation into the lawfulness of the annual access tariffs filed by GTE Services Corporation (GTE) on behalf of its affiliated GTE Telephone Operating Companies (GTOC) and GTE System Telephone Companies (GSTC). The Bureau concluded that the exogenous cost adjustments to its price cap indexes that GTE proposed to reflect the sale of several local exchange properties warranted further investigation.[2] In this Order, the Bureau designates issues in this investigation and addresses certain procedural issues.

[1] 1995 Annual Access Tariff Filings of Price Cap Carriers, Memorandum Opinion and Order Suspending Rates, DA 95-1631 (rel. July 21, 1995) (*Price Cap Carriers' 1995 Access Order).*

[2] *Id.* at para. 43.

II. BACKGROUND

2. In the *First Report and Order* in the local exchange carrier (LEC) price cap performance review proceeding,[3] the Commission found that sales or swaps of telephone exchanges should result in an exogenous adjustment to the carrier's price cap indices (PCIs).[4] Specifically, the Commission concluded that price cap regulation[5] may create an incentive for LECs to sell or swap local telephone exchanges for which costs exceed the LEC's average costs.[6] The LECs' PCIs were "initialized" at the time the carriers switched from rate of return regulation to price cap regulation based on their costs of providing interstate service at that time.[7] If LECs were not required to adjust their PCIs to account for the sale of above-average cost telephone exchanges, the LECs, *ceteris paribus,* would realize unwarranted higher earnings on their remaining investment. Accordingly, the *First Report and Order* requires LECs to lower their PCIs to reflect the effects of a sale or swap of above-average cost local telephone

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[3] Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, First Report and Order, 10 FCC Rcd 8962 (1995) (*First Report and Order).*

[4] *First Report and Order*, at para. 328.

[5] The LEC price cap plan was designed to stimulate some of the efficiencies found in the competitive markets and to act as a transitional regulatory scheme until the advent of actual competition makes price cap regulation unnecessary. Price cap regulation encourages LECs to improve their efficiency by harnessing profit-making incentives to reduce costs, invest efficiently in new plant and facilities, and develop and deploy innovative service offerings. Traditional rate of-return regulation provides few incentives for carriers to become more innovative and efficient, and encourages carriers that participate in competitive and noncompetitive markets to shift costs from competitive to non-competitive services. *See* Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, 5 FCC Rcd 6786 (1990) (*LEC Price Cap Order), recon.*, 6 FCC Rcd 2637 (1991) (*LEC Price Cap Reconsideration Order), aff'd sub. nom. National Rural Telecom Assoc. v. FCC,* 988 F.2d 174 (D.C. Cir. 1993).

[6] *Id.*

[7] The PCI indicates the maximum level that LECs may charge for services covered by the index. The PCI is adjusted each year based on a measure of inflation that embodies economy-wide productivity gains and price changes. The PCIs were "initialized" by being set at a value of 100, consistent with the economic conventions normally applied to such indices. The initial rates for services were the cost-based rates established at the end of rate-of-return regulation. Adjusting the PCI downward to remove costs associated with high cost exchanges that have been sold acknowledges that the initial rates under price cap regulation would have been lower if service costs associated with the high cost exchanges had been excluded.

exchanges.[8]

3. LECs subject to price cap regulation filed their 1995 annual access tariff filings on May 9, 1995. GTOC and GSTC indicated in the documentation accompanying their 1995 annual access tariff filings that they had recently completed the sale of several local exchange properties.[9] The carriers further claimed that they had removed the costs and revenues related to these sales from the calculation of their proposed PCIs through an exogenous cost adjustment.[10]

4. As discussed in the *Price Cap Carriers' 1995 Access Order,* AT&T filed a petition against the GTOC and GSTC annual access tariff filings. AT&T alleged that these filings failed to include any cost information to support the PCI adjustments related to the sale of telephone exchanges, thus making it impossible for interested parties to review their adjustment calculations.[11] Moreover, AT&T challenged GTOC's proposal to increase its PCIs to reflect an exogenous cost adjustment of more than $441,000 attributed to GTOC's sale of exchanges in California, Missouri, Oregon, and Washington. AT&T contended that this proposed adjustment is contrary to the Commission's finding in the *First Report and Order* that the sale of exchanges should result in negative exogenous adjustments to the PCIs of the selling LECs.[12]

5. GTE, on behalf of GTOC and GSTC, replied that no exogenous cost adjustment was necessary as a result of the sale of the GTOC-Montana study area and the

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[8] *First Report and Order,* at para. 328.

[9] GSTC indicated that during the period covered by the 1995 annual access tariff filing it had completed the sale of eleven exchanges in Missouri and two exchanges in Texas. GTOC indicated that during the relevant period it had completed the sale of five exchanges in California, three exchanges in Missouri, twelve exchanges in Oklahoma, ten exchanges in Oregon, seventeen exchanges in Texas, and three exchanges in Washington.

[10] GTOC Transmittal No. 963, Description and Justification (D&J), at 2-3; GSTC Transmittal No. 146, D&J at 2-3. Under price caps, most increases and decreases in a carrier's cost of providing regulated service are treated as "endogenous" changes, *i.e.,* they do not result in adjustments to the carrier's PCI. The Commission, however, identified certain cost changes triggered by administrative, legislative, or judicial action that because they are beyond the control of the carriers, should result in an adjustment to the PCI. The Commission found that those types of cost changes should be treated as "exogenous" changes in order to ensure that price cap regulation did not lead to unreasonably high or unreasonably low rates. *See LEC Price Cap Order*, 5 FCC Rcd at 6807.

[11] *Price Cap Carriers' 1995 Access Order*, at para. 40.

[12] *Id.*

GSTC-Arizona-West, Maine, New Hampshire and Vermont study areas because when these properties were sold in 1994, all of the rates for these exchanges were removed from the respective GTOC and GSTC tariffs.[13] With respect to the sale of these exchanges, GTE maintained, no rates remained in the price cap baskets and thus there were no associated PCIs to adjust for the sales of these exchanges in its 1995 annual filing.[14] With regard to the sale of the exchanges in California, Missouri, Oregon, and Washington, GTE explained that it proposed to adjust its PCIs to reflect cost reductions such as Long Term Support (LTS) payments[15] attributable to the sale of those exchanges. GTE claimed that it computed the exogenous cost adjustment by multiplying the total amount of the exogenous costs for the study area by the ratio of the total interstate revenues of the exchanges to the total study area interstate revenues.[16]

6. In the *Price Cap Carriers' 1995 Access Order*, the Bureau found that the manner in which GTE calculated its exogenous cost adjustments for the sale of telephone exchanges, particularly in view of GTE's proposed increase to its PCIs, raised substantial questions of lawfulness that warranted an investigation.[17] The Bureau therefore suspended the affected tariffs for one day, imposed an accounting order, and initiated an investigation. The Bureau indicated that we would designate issues for investigation in a subsequent Order.[18]

III. ISSUES DESIGNATED FOR INVESTIGATION

7. The Bureau hereby designates the following issues in the investigation of the GTOC and GSTC 1995 annual access tariff filings and requests the following information from GTE on behalf of the two carriers:

Issue I: Are the GTOC and GSTC exogenous cost adjustments related to the sale of telephone exchanges adequately supported?

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13 *Id.* at para. 42.

14 *Id.*

15 LTS payments flow from telephone companies that are not in the National Exchange Carrier Association (NECA) Common Line tariff to those companies that do participate in NECA Common Line tariff. LTS enables NECA Common Line tariff participants to charge a Common Line rate equivalent to the common line rate that would result if all telephone companies participated in the association Common Line tariff. *See* Section 69.2(y) of the rules, 47 C.F.R. § 69.2(y).

16 *Price Cap Carriers 1995 Access Order*, at para. 42.

17 *Id.* at para. 43.

18 *Id.* at paras. 43 and 102.

8. We direct GTE to explain fully the methodology used to calculate the exogenous cost adjustments related to the sale of GTOC and GSTC telephone exchanges during the period covered by the 1995 annual access tariff filing. In particular, GTE should explain the calculations and the data underlying the proposed increase of GTOC's PCIs attributed to the sale of exchanges in California, Missouri, Oregon, and Washington in light of the Commission's requirement that LECs lower their PCIs to reflect the effects of such sales. GTE must provide all relevant accounting entries, cost support information, calculations, and relevant workpapers in explaining how it calculated its proposed PCIs. We also direct GTE to submit information regarding: (1) the study areas from which exchanges were sold during the period covered by the 1995 annual access tariff filing; (2) the names of the exchanges that were sold within each study area; (3) the date each exchange was sold; and (4) the exogenous cost adjustment attributable to each exchange that was sold.

Issue II: Have GTOC and GSTC used a reasonable methodology to determine the downward exogenous adjustment to their PCIs attributable to the sale of exchanges?

9. In this investigation, we seek comment from GTE and interested parties regarding the most effective method for assigning costs from a study area to particular exchanges[19] that are sold in order for GTOC and GSTC to adjust their PCIs to reflect the sale of those exchanges. Because some expense accounts are maintained at the study area level, costs from a study area must be assigned to an exchange area being sold. Under the Commission's Part 32 rules, GTE affiliate telephone companies must establish and maintain records for each class of property recorded in the several plant accounts that comprise Account 2001, Telecommunications Plant in Service, Account 2002, Property Held for Future

[19] A study area is a geographical segment of a carrier's telephone operations. Generally, a study area corresponds to a carrier's entire service territory within a state. Thus, carriers operating in more than one state typically have one study area for each state, and carriers operating in a single state typically have a single study area. Carriers perform jurisdictional separations at the study area level. For jurisdictional separations purposes, the Commission adopted a rule freezing study area boundaries, effective November 15, 1984. *See* Part 36 of the Commission's Rules, 47 C.F.R. Part 36, Appendix-Glossary, definition of "Study Area." *See also* MTS and WATS Market Structure, Amendment of Part 67 of the Commission's Rules and Establishment of a Joint Board, CC Docket Nos. 78-72 and 80-286, 49 Fed. Reg. 48325 (Dec. 12, 1984) (*1984 Joint Board Recommendation),* adopted by the Commission, 50 Fed. Reg. 939 (Jan. 8, 1985) (*1985 Order Adopting Recommendation*). *See also* Amendment of Part 36 of the Commission's Rules and Establishment of a Joint Board, CC Docket No. 80-286, *Notice of Proposed Rulemaking*, 5 FCC Rcd 5974 (1990) (*Study Area Notice*).

Telecommunications Use, and Account 2006, Nonoperating Plant.[20] These property records must be maintained in order to identity the vintage, location and original cost of the property, and to account accurately for plant retirements.[21] Therefore, with respect to assets, the Commission's accounting system currently captures information related to the assets sold in an exchange sales transaction. Most expenses incurred by carriers, however, are typically aggregated at the study area level of detail and thus it is unclear at what level of detail these expenses are recorded for individual exchanges.

10. In its 1994 annual access filing, US West Communications, Inc. (US West) presented a methodology for allocating costs aggregated at the study area level among individual exchanges within the study area.[22] US West proposed, in conjunction with a petition for waivers of the frozen study area boundary rule, to make an exogenous cost reduction to its PCI equal to the net reductions in its interstate revenues resulting from the sale of 43 exchanges.[23] Because these exchanges comprised parts of study areas rather than whole study areas, the transfer of those exchanges to other LECs would have altered the boundaries of US West's existing study areas. It was therefore necessary for US West to obtain waivers of the rule freezing study area boundaries. The Bureau granted the study area waivers on the condition that US West execute the necessary exogenous cost reductions.[24]

11. US West's methodology is designed to calculate the increase in net revenue resulting from the sale of high cost exchanges. US West first calculated historical revenues for the exchanges being sold,[25] and then calculated the capital and operating costs associated with these exchanges.[26] Where necessary, US West used an allocator to assign a portion of study area costs to the exchanges sold. US West allocated certain capital expense items based upon the ratio of "Total Plant in Service (TPIS)" associated with the exchanges sold to the TPIS in

[20] *See* 47 C.F.R. § 32.2000 (e)(4). Part 32 of the Commission's rules contains the Uniform System of Accounts (USOA) for telecommunications companies, which is a historical financial accounting system companies must adhere to in booking their various accounts. The USOA is comprised of different accounts, to which companies book associated costs.

[21] *See* 47 C.F.R. §§ 32.2000 (e)(1) and 32.2000 (e)(7)(i)(B).

[22] US West Transmittal No. 465, D&J at Section 1.2.5 (filed Apr. 1, 1994).

[23] *See* Letter from Laura Ford, US West, to Kathleen Levitz, Acting Chief, Common Carrier Bureau, August 6, 1993; Letter from Laura Ford, US West, to A. Richard Metzger, Acting Chief, Common Carrier Bureau, June 23, 1994.

[24] *See, e.g.,* US West and Central Utah Telephone, 9 FCC Rcd 194 (Com. Car. Bur. 1993).

[25] *Id.* at 1-8.

[26] *Id.*

the study area. It estimated labor expenses based on the workforce requirements and labor rates of the exchanges.[27] Finally, other operating expenses were allocated by developing a per line operating expense for the study area and multiplying this amount by the number of access lines in the particular exchange being sold.[28]

12. Under US West's methodology, the total costs attributed to the sold exchanges equaled the sum of the total annual capital and operating expenses attributable to them. For purposes of adjusting the PCIs, the exogenous cost change related to an exchange sale transaction equaled the revenues generated by the operation of the exchanges sold less the total costs attributed to the exchanges.[29] Applying US West's methodology would lower a LEC's PCIs if the costs attributed to exchanges that were sold exceeded the revenues generated by those exchanges. The Bureau is concerned that GTOC and GSTC did not use an appropriate methodology to determine the downward adjustments to their PCIs attributable to their sale of exchanges. Therefore, GTE is directed to use US West's methodology to calculate the downward exogenous adjustment to GTE's PCIs required to reflect the sale of GTOC and GSTC telephone exchanges during the period covered by the 1995 annual access tariff filing. GTE should explain in detail whether or not this method produces the required adjustments. The Bureau also seeks comment from interested parties on whether GTOC and GSTC should use US West's methodology to determine the downward adjustment required to reflect their sale of telephone exchanges.

13. In addition, GTE is directed to discuss whether it would be preferable to require GTOC and GSTC to use an alternative methodology that is based upon cost causation to assign costs from the study area to the exchange sold. Specifically, we direct GTE to use the methodology described in the following paragraphs to calculate downward exogenous cost adjustments to GTOC's and GSTC's PCIs attributable to the sale of telephone exchanges covered by the 1995 annual access tariff filing. We also direct GTE to discuss whether this alternative methodology measures cost savings associated with telecommunications operations attributable to the sale of exchanges more accurately than the US West methodology. We seek comments from interested parties on this methodology and its comparative advantages and disadvantages. This methodology requires the specific identification of net book costs associated with the assets that were sold, and involves the use of various allocators to derive expenses associated with each exchange that was sold. The net book cost for assets sold are available from the selling carrier's basic property records. Thus, for accounts relating to TPIS (Part 32 Accounts 2111-2690[30]), GTE should provide the original cost and the associated depreciation reserve for all the assets sold in the GTOC and GSTC exchanges covered by the 1995 annual filing.

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[27] *Id.* at 1-9.

[28] *Id.*

[29] *Id.* at 1-10.

[30] *See* 47 C.F.R. §§ 32.2111-32.2690.

14. Once GTE identifies the specific assets that were transferred when an exchange was sold, the expenses associated with each plant account and all other expenses associated with the exchange need to be identified. GTE can identify these other expenses by using allocators to assign costs from the study area level to the exchange level. Under this methodology, GTE should apply three allocators to different accounts depending on which allocator best reflects cost-causative principles. The first allocator should be based on the relationship between the specific TPIS of the exchange that was sold and the total study area TPIS. This allocator should equal the TPIS sold divided by the total TPIS for the study area multiplied by the study area plant specific operations expense amount associated with each expense account. GTE should apply this specific allocator to Part 32 accounts for which the allocator would more accurately reflect exchange-specific costs, such as expenses related to switching equipment.[31] These types of expenses can be correlated more closely with individual exchanges.

15. The second allocator allocates costs related to customer and corporate operations to the exchange that was sold. Customer operations expenses (Part 32 Accounts 6611-6623[32]) should be assigned to the exchange sold based on the number of subscribers served by the exchange sold divided by the total number of subscribers served in the study area. For each of these accounts, the subscriber ratio should be multiplied by the amount in that account attributable to the study area. Corporate operations expenses (Part 32 Accounts 6711-6790[33]) should be allocated in the same manner to the exchange that was sold.

16. The third allocator is a general allocator that should equal the total gross TPIS[34] for the sold exchange divided by the total gross TPIS for the study area multiplied by each of the remaining expense accounts associated with the relevant study area. GTE should apply this general allocator to certain plant specific operation expenses (Part 32 Accounts 6112-6120[35]), certain plant non-specific operation expenses (Part 32 Accounts 6511-6535[36]) and the federal and state tax expense accounts (Part 32 Accounts 7210-7250[37]). This general allocator should be used to develop estimates of costs to be attributed to the sold exchanges for expense

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[31] *See e.g.* Part 32 Accounts 6121-6441, 47 C.F.R. §§ 32.6121-32.6441.

[32] *See* 47 C.F.R. §§ 32.6611-32.6623.

[33] *See* 47 C.F.R. §§ 32.6711-32.6790.

[34] The total gross TPIS equals the sum of all TPIS accounts.

[35] *See* 47 C.F.R. §§ 32.6112-32.6120.

[36] *See* 47 C.F.R. §§ 32.6511-32.6535.

[37] *See* 47 C.F.R. §§ 32.7210-32.7250.

accounts for which levels can not be specifically associated with plant investment or for which amounts are more closely tied to total study area operations.

17. In addition to the foregoing issues, GTE and interested parties may discuss the methodology that LECs should be required to use to determine exogenous adjustment required by the sale or swap of an entire study area. In the *First Report and Order*, the Commission observed that because some price cap LECs apply a single PCI to a region containing many study areas, these LECs could increase their earnings under price cap regulation by selling higher-cost study areas to rate-of-return LECs without lowering their PCI.[38] Hence, the Commission emphasized that price cap regulation could "contain a perverse incentive for price cap LECs to sell whole study areas, without corrective action by the Commission."[39] Accordingly, the *First Report and Order* requires price cap LECs selling whole study areas to lower their PCIs to remove the effects of the transferred properties from price-capped rates.[40] While GTE's 1995 annual access tariff filings did not raise questions regarding the sale of entire study areas, we nevertheless seek comment on whether the sale of entire study areas requires the use of a methodology different from the one that would be used to account for the sale of individual exchanges.

IV. PROCEDURAL MATTERS

A. Filing Schedules and Procedures

18. This investigation, to be identified as CC Docket No. 96-xx, will be conducted as a notice and comment proceeding during which GTE bears the burden of proof to show that its tariff revisions are lawful. GTE is designated as a party in this proceeding and shall file its direct case no later than February 20, 1996. The direct case must present the party's position with respect to the issues described in this Order. Pleadings responding to the direct case may be filed no later than March 5, 1996 and must be captioned "Opposition to Direct Case" or "Comments on Direct Case." The parties may each file a "Rebuttal" to oppositions or comments no later than March 19, 1996.

19. An original and four copies of all the pleadings must be filed with the Secretary of the Commission. In addition, one copy must be delivered to the Commission's commercial copying firm, International Transcription Service, Room 246, 1919 M Street, N.W., Washington, D.C. 20554. Members of the general public who wish to express their views in an informal manner regarding the issues in this investigation may do so by submitting one copy of their comments to the Secretary, Federal Communications Commission, 1919 M Street, N.W.

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[38] *First Report and Order*, at para. 330.

[39] *Id.*

[40] *Id.*

Room 222, Washington D.C. 20554. Such comments must specify the docket number of this investigation.

20. All relevant and timely pleadings will be considered by the Commission. In reaching a decision, the Commission may take into account information and ideas not contained in pleadings, provided that such information or a writing containing the nature and source of such information is placed in the public file, and provided that the fact of reliance on such information is noted in the Order.

B. Ex Parte Requirements

21. *Ex parte* contacts (*i.e.* written or oral communications which address the procedural or substantive merits of the proceeding which are directed to an member, officer, or employee of the Commission who may reasonably be expected to be involved in the decisional process in this proceeding) are permitted in this proceeding until the commencement of the Sunshine Agenda period. The Sunshine Agenda terminates when a final Order is released and the final Order is issued. Written *ex parte* contacts and memoranda summarizing oral *ex parte* contacts must be filed on the day of the presentation with the Secretary and Commission employee receiving each presentation. For other requirements, *see generally* Section 1.200 *et seq.* of the Commission's Rules, 47 C.F.R. §§ 1.200 *et seq.*

C. Paperwork Reduction Act

22. The investigation established in this Designation Order is not subject to the provisions of Section 3507 of the Paperwork Reduction Act of 1995, as amended.

V. ORDERING CLAUSES

23. ACCORDINGLY, IT IS ORDERED that, pursuant to Sections 4(i), 4(j) 201(b), 204(a), 205 and 403 of the Communications Act of 1934, 47 U.S.C. §§154(i), 154(j), 201(b), 203(c), 204(a), 205, and 403, the issues set forth in this Order ARE DESIGNATED FOR INVESTIGATION.

24. IT IS FURTHER ORDERED that GTE Services Corporation SHALL BE a party to this proceeding.

25. IT IS FURTHER ORDERED that GTE Services Corporation SHALL INCLUDE in its direct case, a response to each request for information that it is required to answer in this Order.

FEDERAL COMMUNICATIONS COMMISSION

Regina M. Keeney

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Chief, Common Carrier Bureau